Brickflow **Property Developer Guides**

Making your equity work harder

If you don't have a hefty deposit to help secure development finance, it doesn't mean it's game over for your ambitious development plans. There are many ways to stretch your equity further and source the funds you need. Here are some of them.

1. Cracking your capital stack

The Capital Stack is the structure of your development finance, or the different layers that fund a scheme. The typical stack has three layers, and normally includes senior debt, mezzanine debt and equity. Strategically determining the best capital stack for your project allows you to minimise your equity investment and maximise your Return on Capital Employed (ROCE). Read our more detailed guide to the Capital Stack.

2. Shopping the market (and why cheap debt is mostly a false economy)

The default setting for many developers is to stick to a tried and tested senior lender. But deposits vary from 10% to 35% of total costs (including land, build, finance and professional fees), so on a scheme with costs of £5m, the required deposit could be anything from £500K to £1.75m. A huge and potentially deal-breaking variance. If you only have a relationship with one lender who requires a deposit at the higher end of the spectrum, it could mean investing an additional £1.25m of equity, blocking investment for other schemes, and preventing you from progressing to bigger sites, sooner.

Here's an example of how shopping around for property development finance can stretch your equity further:

- A site has combined land and build costs of £6m
- GDV is £9m and build term is 12 months
- Exit strategy is sale of the units, so with an 18-month loan term there is 6 months to sell the units
- Two developers have £1m of equity each

Developer X keeps it traditional

- Borrows from a high-profile High-Street lender. Rate is good at 5%, but he needs £2.1m in equity (35% of costs)
- He invests £1.1m of his own equity and finds £1.1m from an investor on a profit share basis
- He agrees to pay the investor 10% interest and 40% of the profit
- Lender costs are £500k, taking total costs to £6.5m
- Profit is £2.5m, so the investor is due £1m (40%) in profit share and £100k in interest (a fantastic return of 100% for the investor)
- Developer X earns a good pre-tax profit of £1.5m in 18 months

Developer Y keeps it smart

- Searches the entire market and finds a different lender
- His rate is higher at 7.5%, but he only has to invest £600k of equity
- He doesn't need an investor and doesn't need to give 40% of his profits away
- The cost of the debt is £800k, so total costs are £6.8m
- The profit is £2.2m, but there is no profit share, so he keeps it all
- He earns £700k (pre-tax) more than Developer X over the same time period (on this scheme)
- He also has £400k of additional equity, so is able to run a second smaller scheme over the same period, which earns him another £1.4m
- He earns £3.6m over 18 months (versus Developer X at £1.5m)
- The only difference is Developer Y shopped around for his funding

Making your equity work harder *contd.*

3. Leveraging your network (smartly)

The best property developers have the ability to bring in the right partners to make a scheme work. This applies to obtaining finance for property development, and making debt work for you. It's unlikely that using a single source of funding is the most cost-effective route, so look to your friends, family and wider professional network to help raise equity where you can.

Having said that, if you need to partner with investors to make a scheme happen, don't be too generous with your profit share. You're the driving force behind the development and without you it wouldn't be on the table, so remember this when assessing your funding options.

Here's an example:

Developer X keeps it traditional

- Borrows £5.5m from a High-Street bank at 5% interest, based on 55% LTGDV on value of £10m
- Total costs are £7.5m (pre-finance), leaving £2m of equity to find
- He has £1m, so needs to find the rest from an investor
- After the finance costs are added, he makes £2m in profit, but has to share half the profits with his investor
- He makes £1m profit, which is good, but could be better

Developer Y keeps it smart

- Shops around and secures a slightly higher rate of 7.5%, but a LTGDV of 65%
- Therefore, he needs only £1m equity, which he has, so doesn't need to find an investor or offer a profit share
- He makes £1.75m profit (after finance costs). An extra £750k over the same period as Developer X

4. Considering a second charge

Second charge loans mean you can use equity in background portfolio properties as security for another loan, even if you have an existing mortgage, so they're a great way to conserve cash. They offer flexible funding, and can normally be secured fairly quickly as second charge lenders are setup to work quickly, making them a strong alternative to re-mortgaging or draining your cash.

If you have some BTL properties in the background that are lowly geared, this could be an option. Lenders can even take a second charge over multiple properties to give you an overdraft type facility to use as and when you need to raise a deposit.

5. Leveraging the planning process

If you buy or option a site without planning permission, you will add value during the planning process, commonly known as sweat equity. This places value on the time and effort put into a project. Securing planning permission isn't easy, so good lenders will take this into account when assessing a funding application for a property development loan, and lending opportunity.

Every lender will place a different amount of value on sweat equity, so make sure you search the market to find one that appreciates the value you add as an experienced property developer.

An added benefit of buying during the pre-planning phase comes if you need an investor. You can repay your equity when you raise the development finance for the build stage, meaning you'll only need to pay your investor a percentage of the profit on the uplift during the planning process, not on the total profits at the end.

Making your equity work harder *contd.*

Here's an example:

- Developer X buys a property for £1m
- He takes a net bridging loan at 70% LTV
- He has £200k in purchase costs and planning costs, so total investment is £1.2m
- He splits the £500k deposit equally with an investor and they agree a 50/50 profit share
- 9 months later he secures planning permission, and the site is worth £2m, so there is £800k of 'profit'
- He owes the investor £250k (his original investment) plus £400k profit share
- He is able to raise development finance of £1.35m + 100% of build costs
- £700k is used to pay the bridging loan back, and the investor is paid £650k (£250k + £400k profit)
- Developer X is able to fully repay his investor after 9 months, meaning he keeps the £2.2m profit the scheme generates once it has been built, rather than paying his investor 50% (£1.1m)

6. Requesting a deferred land payment

When a developer is looking to buy a piece of land, the landowner can agree to receive part of the payment once the properties have been built and sold (usually at a higher price as the trade-off). This is known as a deferred land payment, and it's worth asking the question if you're short on equity. The lender providing the development finance has first charge over the land and lends all of the build costs, plus a portion of the land acquisition costs.

As the buyer, you would be giving the lender security over a site that is worth more than you paid for it (so far). This de-risks the lender and allows you access to greater value projects with smaller deposits, so it's a full circle win. The landowner will normally request a second charge behind the lender and would have to agree to be repaid only after the lender. Not every vendor will agree to this, so you need a good relationship in place. You could also offer a small profit share to further sweeten the deal (if needed).

Not many developers are aware of this strategy, and not every lender will agree to a deferred land payment. If they do, each lender will take a different approach, so seek expert advice from a broker before choosing your loan for property development.

The figures in the worked examples are for illustrative purpose only.